Treatment of Medicaid Wavier Payments for Purpose of EITC and ACTC

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In May 15, 2019, the U.S. Tax Court issued its decision in the *Mary K. Feigh,* 152 T.C. No. 15 (2019) case. The Court held that earned income "cannot be reclassified by [the IRS], through a notice, to fall outside the plain text of section 32." Judge Goeke described this case as involving a "novel question." It is also one that may affect some low-income taxpayers.

Background of the Case

Mary K. Feigh (W) and Edward M. Feigh (H) claimed an earned income tax credit (EITC) and an additional child tax credit (ACTC) on their 2015 tax return. Their only income was from Medicaid waiver payments W received for care in their home of the couple's disabled adult children. Medicaid waiver payments are treated as difficulty of care payments according to IRS Notice 2014-7, with such payments excludable from gross income under section 131.

The Form W-2 received in 2015 for the waiver payments reported $7,353. H and W reported this income on their return but then excluded it from the calculation of gross income based on the instructions to Form 1040 and IRS guidance. Despite excluding the payments from their gross income, they used the income to claim an EITC of $3,319 and ACTC of $653, which represented the refundable portion of the child tax credit.

The Feighs received a notice of deficiency from the IRS disallowing the EITC and ACTC. According to section 32(c)(2)(A), a taxpayer must have "earned income" for a taxable year to qualify for EITC or ACTC. The IRS argued that the Feigh's Medicaid waiver payments were properly excluded from gross income and thus, did not qualify as "earned income." Therefore, they were not entitled to the EITC or ACTC for 2015.

The issue before the court was whether Medicaid waiver payments, treated as difficulty of care payments and excludable from gross income pursuant to Notice 2014-7, qualify as "earned income" for determining eligibility to receive the EITC and ACTC.

What is Qualified as Earned Income?

"Earned income" is defined under section 32(c)(2)(A)(i) as "wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year." According to section 131, qualified foster care payments received by an individual provider of foster care during the tax year are excluded from the individual's gross income. The IRS tried to classify Medicare waiver payment as difficulty of care payment, a type of qualified foster care payment under section 131 and excludible from gross income. Section 131(c)(1)(A) defines difficulty of care payments as "compensation for providing the additional care of a qualified foster individual". A "qualified foster individual" is "any individual who is living in a

foster family home" and who was placed there by an agency of the State or a qualified foster care placement agency.[1]

Medicare waiver payments were not excludible under section 131 prior to Notice 2014-7, because such payments were for biological parents taking care of their disabled child in their own house, which is different from foster care. Their relationship was not a foster care relationship and compensation the state paid to W under a state Medicaid waiver program to care for their disabled adult children were not excludable from income as a difficulty of care payment.

The IRS basically turned "earned income" into "unearned income" without authority. There was no "statutory, regulatory, or judicial authority" that could support the IRS's treatment. The court emphasized that IRS notices are "mere statements of the Commissioner's position" and "lack the force of law."

Includible versus Included

The court emphasized that section 32 includes the phrase "includible in gross income." The court noted that "includible" and "included" are not the same words. The court referred to and explanation from *Tesco Driveaway Co. v. Commissioner* [2] that "included" means the actual treatment of income. "Includible" means a legal requirement of income, whether or not the income was actually so treated. In other words, an item of income is *included* in gross income means that it was actually included in the taxpayer's gross income, while income *includible* in gross income means that it is required to be included in gross income, whether or not the item was actually included. The court held that the Feigh's Medicaid waiver payment was not included in their gross income, but it was legally includible in their gross income. Thus, the Feighs were found to be eligible to claim the EITC.

Lack of Authority

Section 24(a) allows a credit to each qualifying child of the taxpayer for which a dependency exemption is allowed under section 151. In this case, section 24(d) allows the Feighs a refundable portion of the child tax credit based on their earned income as defined under section 32. There is a credit allowed against the tax imposed on earned income, the EITC. It is a tax credit for certain people who work and have earned income under $55,952. These tax credits are granted by Congress. The question in the *Feigh* case was whether the IRS can deny these credits and remove a statutory benefit through a notice. The court referred to *Commissioner v. Schleier* [3] which held that "interpretive rulings do not have the force and effect of regulations and they may not be used to overturn the plain language of a statute." The court also cited *Deputy v. Du Pont,*[4] that deductions and credits "depend upon legislative grace and are allowed only to the extent authorized by statute." The EITC and ACTC are allowed per

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[1] IRC § 131(c)(1).

[2] *Tesco Driveaway Co. v. Commissioner*, T.C. Memo. 2001-294.

[3] *Commissioner v. Schleier*, 515 U.S. 323 (1995).

[4] *Deputy v. Du Pont*, 308 U.S. 488 (1940).

legislative grace by Congress. Therefore, the IRS has no authority to deny the credits authorized by statute; that is a power only Congress has. Thus, the court ruled that the IRS could not deny the Feighs benefit of these credits via Notice 2014-7. In other words, the IRS could not "remove a statutory benefit provided by Congress" through a notice or make its own assumption.

Conclusion

As a result, the Tax Court ruled that Medicaid waiver payments, even though excluded from income by the IRS, are still earned income for purposes of claiming the EITC and ACTC. This is a novel case about how to interpret a law and who has the power to interpret a law.

What's Next?

Medicaid waiver payments have been required to be excluded from gross income since 2014. The IRS updated 20 new Q&As to address confusion and concerns. However, the question whether to include the Medicaid waiver payments in gross income is reserved in 2020 because of the *Feigh* case. The main question right now is whether taxpayers can both exclude the payments from income and claim a credit. In 2019 IRS VITA Publication 4012, Medicaid waiver payments are still excluded from income but are not considered earned income for the EITC. This is an interesting tax rule and taxpayers should follow how it might change in the future either by, for example, the IRS changing Notice 2014-7 or Congress making a change.